

MOODY'S CHANGES OUTLOOK ON DISTRICT OF COLUMBIA'S BAA1 GENERAL OBLIGATION BONDS TO POSITIVE

\$3.0 BILLION OF DEBT AFFECTED

District of Columbia
State
District of Columbia

NEW YORK, March 19, 2003 -- Moody's has changed the rating outlook of the District of Columbia's Baa1 general obligation bonds to positive from stable. Approximately \$3.0 billion of outstanding general obligation debt is affected. The positive outlook stems from both the financial results shown in the recently released 2002 Annual Audit and the District's strong response to a large projected budget gap in fiscal 2003, primarily employing timely spending controls. The bulk of the budget adjustments made last fall appear to have been successful, and the remainder of the gap is expected to be closed through new spending adjustments and a fairly modest use of reserves. These actions demonstrate the commitment of the District's leaders to maintain a strong fiscal position, even in the face of economic softening. At the same time, the District economy has held up relatively well in the last year, as evidenced by continued residential and commercial property tax base growth, and one of the lowest office vacancy rates in the country. Employment trends are down moderately, however.

More broadly, the Baa1 rating reflects: (i) recent years' stabilization and improvement in the District's economy and tax base; (ii) good financial results over the past six years, mainly as a result of local tax revenue performance, the permanent shift of some program costs to the federal government, and improved financial oversight and management (despite recurring episodes of overspending vs. budget by some agencies); and (iii) a high-but-manageable burden of tax-supported debt. The rating also reflects the District's need to improve the quality and efficiency of public services, particularly K-12 education, in order to sustain positive trends in the economy and District finances.

2002 AUDIT CONFIRMS SIXTH YEAR OF BALANCED OPERATIONS AND LARGE ACCUMULATED RESERVES

Released in January, the District's 2002 audited financial statements show the District logged a \$27.4 million General Fund surplus, the sixth consecutive year of both balanced operations and a clean opinion of the audit process offered by the auditor. Since 1997, the District has logged operating surpluses, which have allowed it to eliminate its accumulated deficit, which had reached \$518 million in 1997. Surpluses also allowed the District to build a substantial fund balance that stood at \$865.3 million at the end of fiscal 2002, or about 24.6% General Fund expenditures.

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The most recent financial results were achieved during a year of economic recession in which the District was affected acutely, due to the District's proximity to the events of September 11. Some of the fund balance, such as the 7% cash reserves, is required by law and has tight restrictions its use. As an additional cushion, the District is required to maintain a Budgeted Reserve in which projected revenues exceed projected expenses by an amount intended as reserve. The fiscal 2003 budget plan includes a reserve of \$70 million. In 2001 and 2002, the Budgeted Reserves were largely consumed by spending pressures, but their presence helped ensure balanced operations. Some of the 2002 fund balance is the unused portion of the 2001 and 2002 budget reserves. The District plans to draw down most of this leftover budget reserve to deal with 2003 spending pressures.

DISTRICT SUCCESSFULLY MANAGES MID-COURSE BUDGET PRESSURES

During the course of fiscal 2002, the District identified and successfully managed \$402 million of budgetary pressures. Despite the prolonged closure and then limited reopening of Reagan National Airport, which was projected to have a big impact on revenues, the bulk of the pressure came from the expenditure side. As has typically been the case in the District, a large chunk of the spending pressure came from the public schools, with significant pressures in children's services, health, and Medicaid. In Moody's opinion, these spending surprises remain an area of vulnerability for the District although they have clearly waned in the last 2 years. Maintaining focus on financial control will be critical for the District going forward as it has been in other turnaround cases.

Fiscal 2003 has been a difficult budgetary year as well. From the budget submitted to Congress in June 2002, the District has identified \$450 million in budgetary shortfalls over the course of the year, \$323 of which was identified and dealt with at the very beginning of the fiscal year. The District's early identification of these pressures made them more manageable and the recently surfaced \$128 million of budget pressures are also likely to be addressed successfully. The currently identified pressures are a mix of economically driven problems, such as revenue weakening and increased demand for human services, and other issues, such as court-ordered costs, snow emergency costs, and increased overtime (a frequent District budget concern). The District plans to address the portion of the weakening that is structural in nature with recurring program cuts of nearly \$70 million. So far, the District is keeping the budgeted reserve of \$70 million intact. In the past, the District has spent this reserve down as necessary and may still do so this year, if further weakening occurs.

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DESPITE EFFECTS OF NATIONAL DOWNTURN, DISTRICT ECONOMY POISED FOR GROWTH

After years of weak growth or decline, the District economy is seeing some positive news although some weakening from the national downturn in the economy is evident. The strongest economic indicators are found in the District's real estate market. The commercial real estate market continues to grow, with 5.6 million square feet under construction. The District stands out for its high rental rates (\$41 / square foot) and a vacancy rate of 4.6%, which is lower than the suburban rates in Maryland or Virginia and most other large U.S. cities. These numbers may improve further as the new convention center opens later this month and expands the boundaries of the downtown core. The residential housing market is also strong, with the average home price of nearly \$400,000 in the last quarter of 2002, and still rising.

Long a negative indicator for the District, the population is beginning to stabilize and District forecasters are even projecting modest growth of 3.5% by 2007. The 2000 Census revealed that population estimates over the past 10 years severely undercounted the actual population in the District. The actual 572,000 population in 2000 was nearly 10% higher than the previously estimated 523,000. While the District still lost 5.7% of its population from 1990 to 2000, that loss was substantially smaller than the 13.8% loss that was forecasted.

Employment numbers are currently showing mixed signs. After decreasing every year from 1990 to 1997, resident employment surged 8% in 1999, but declined slightly in 2001 and 2002, and is projected to decline again in 2003, with a rebound beginning in 2004. Moody's considers resident employment a pivotal statistic in the District's economic health because it is the income from these jobs that the District can tax. The total non-farm employment number, which encompasses all employment in the District including those jobs held by suburban commuters, is generally holding steady, with a slight decline in 2002, but growth again projected for 2003 and after. While the District cannot tax commuter income, those jobs still contribute vital revenues to the District in the form of sales and gross receipts taxes, among others, and indirectly in the form of property tax on commercial real estate.

Personal income, an indicator by which the District has always compared favorably to the country on a per-capita basis, was about 131% of the national per capita personal income in 2001, higher than the neighboring states of Virginia and Maryland, and about equivalent to New York City. The District's unemployment rate has historically been higher than the nation's and especially the surrounding Maryland and Virginia suburbs, and that gap persists. Most recently, the December unemployment rate was 6.2% in the District, compared to 3.1% in the metropolitan area and 5.7% in the nation overall. The District's unemployment rate will likely always fluctuate more than other cities', reflecting the fluidity of the District's employment base and the political cycles that drive the city.

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FUTURE BORROWING NEEDS TO KEEP DISTRICT'S DEBT RATIOS HIGH BUT MANAGEABLE

Reflecting in part the District's role as both city and state, as well as the impact of an earlier deficit financing, the District's debt ratios are high, with a tax-supported debt per capita of \$6,520 and debt to full value at 7.1%. While above comparable medians for either cities or states, this number is down from the previous ratios, which approached \$7,000 and 9.0%. The District's annual debt service (excluding water and sewer and convention center debt) is currently about 7.5% of local General Fund revenues, well within the District's rather loose debt limitation of 17%.

The District lowered its debt burden by using some of its past surpluses (\$120 million of the surplus from fiscal 2000) to defease debt. In addition, the proceeds of District's \$521.1 million tobacco securitization bond sale were used to defease or refund \$482 million of outstanding general obligation bonds. These debt ratios will likely climb again, as the District tries to address its significant deferred capital needs.

Another important aspect of the tobacco bond financing is that the general obligation debt service savings from it have been used to fill cash reserves. The Fiscal 2001 Appropriations Act required that an amount equal to the debt service savings from the securitization be placed into the Emergency Reserve until the reserve is fully funded, which has now been achieved.

OUTLOOK

The outlook for the District's general obligation bond rating is positive. The District has managed its finances to a positive outcome through a period of significant economic uncertainty. As required by law, the District has maintained significant reserves, much of which is in cash, at a time when many states and cities have depleted much of their fiscal cushion. Future rating action will hinge on the District's efforts to improve the quality and efficiency of its public services within its limited resource base, and on the progress of the District economy in maintaining its positive momentum.

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